Systemic Risks to the U.S. Financial System Posed by China

How should investors react when confronted with a country like China, with which we have a deep and broad economic relationship but that does not follow the norms of membership in the community of nations?

Large and influential nations generally abide by certain norms: other countries expect them to report true information, generally to refrain from stealing technology, to abide by international agreements, and to use established fora to address dissatisfactions with those agreements. China often ignores these norms. Over four decades of growth and investor enthusiasm, China has integrated only very poorly with the global system of governance.

This institutional sclerosis has several consequences:

Fraud on U.S. markets: There is no regulator in China that concerns itself with the integrity of companies that list overseas, and, for Chinese aspirants, achieving a U.S. IPO is considered a brass ring – a golden ticket for pulling in capital. Companies have every incentive to issue deliriously promotional results and little incentive to report negative information. Falsification of results, consequently, is rampant among Chinese-domiciled companies listed in the United States, and even when exposed, they face no consequences, because U.S. law does not reach into China.

A decade ago, rapid-fire exposes of companies like Sino-Forest and Orient Paper brought down their market values. The Chinese software company Longtop Financial disclosed that it had lied about having $1 billion in the bank—the exact same lie that a decade later landed the CEO of the German company Wirecard in jail, but Longtop simply de-listed then carried on its business as usual.

Even when formerly celebrated companies defaulted on debt and declared bankruptcy, U.S. investors generally have not gotten a payout. A typical example is Suntech, a company that made solar panels for the export market and listed on the New York Stock Exchange in 2005 with the ticker STP. The company publicly expressed shock to learn that the collateral for $750 mln of its debt was fraudulent. When STP defaulted on a $541 principal payment on convertible bonds, it "discovered" it had no collateral to sell off to support the debt. In bankruptcy, Suntech then transferred assets from overseas to its Wuxi headquarters company, where the laws of foreign jurisdictions do not reach.

LDK Solar, another lion of China’s solar industry, went through something similar. About to miss a bond payment, LDK announced that it would restructure. But the company got approval from a court in the Cayman Islands to appoint “joint provisional liquidators” to negotiate with overseas holders of the company’s debt. The creditors got about 8% of their debt in new equity in LDK, while the remaining 92% or so received a new bond at lower interest and an extended term. The agreement did not affect the operations of LDK's Chinese company, whose assets then amounted to $4.3 bln.

VIEs and other workarounds: The legal workarounds through which listed companies access foreign investment are unreliable and provide no guarantee of the rights of ownership.

The most valuable portions of China's Internet, such as the search algorithms, news reporting, and video rights, are by law owned by Chinese nationals. Public-market investors participate in the companies' profit by proxy. So how can Americans invest in companies like Alibaba (BABA), Netease (NTES), and Baidu (BIDU)? They use Variable Interest Entities or "VIEs."

This is how it works: the important bits of the company are owned by individual Chinese managers. Companies controlled by public investors get contractual rights to the profit streams. Those profit streams must be disguised as service payments. There is a system of protocols in place allowing public owners to oust the Chinese owner/managers of the VIE companies. For example, the Chinese owners pre-sign resignation letters that are kept in lock box against the eventuality of those managers going wildcat. The idea is that the Chinese staff may own the crown jewels, but the public investors hold a nuclear solution that allows them ultimately to control the key assets.

Investment banks and companies like Baidu have regularly assured investors that Chinese authorities would never touch the VIE structure. But Beijing has made threats against the VIE structure with some regularity. In 2021, for example, China said it would likely ban market listings through VIE structures.

There is precedent for abruptly reversing course on structures that had been green-lighted at a very high level. In 1994, the telecom company Unicom was formed as a foil to the monopoly telecom service provider. Unicom had nothing: no technology, no money, and no management skill. In order to get the capital and technology to build a credible company, Unicom formed joint ventures with foreign telecom carriers. Foreign ownership was not permitted in the industry, so they had to develop a work-around. This work-around was dubbed "Chinese-Chinese-Foreign," or CCF, and mirrored the current VIE structure. Companies like Bell South would choose employees to be the nominal owners of fully domestic companies, which would then joint venture with China Unicom. The arrangement was publicly praised by then-Premier Zhu Rongji.

In summer 1998, all this changed. Premier Zhu signed a decree requiring that all the foreign partners exit the trilateral arrangements and the joint ventures be unwound. To this day, despite China's accession to the WTO with its Telecom Services agreement, international telecom carriers have no role in the Chinese market.

Human rights and workers' rights are ignored: The most important principle of Chinese governance is the primacy of the CCP. Consequently, although there is a dense lattice work of laws and regulations that ostensibly protect individual rights, those rules are regularly ignored when the Party believes its own dominance may be under threat. The oppression of Uyghurs in Xinjiang is well understood internationally, but political authorities rebuff appeals to Chinese law. The same has been true of other rights violations, such as the arrest of lawyers, persecution of dissidents, and harvesting of organs from condemned prisoners.

Threats perceived by foreign nationals: Because of the politically colored nature of China's laws and regulations, American citizens and their property lack a guarantee of safety within China. Ever since China detained "the two Michaels" (Canadian citizens Michael Spavor and Michael Kovrig) in 2018 as bare-knuckled leverage against Canada's house arrest of Huawei executive Meng Wanzhou, foreign nationals have been concerned that, if they travel to China, they might be detained or subjected to an exit ban and kept in China indefinitely.

The most common reason for exit bans for foreigners is a commercial dispute to which the banned individual is relevant by being a local company executive or having been a member of a foreign company's management team - even if many years earlier. Many of those banned from exit do not know that there is a commercial dispute at all. China also detains people on criminal charges, but those are more often conducted under a broad national-security law rather than over a commercial dispute. Detentions purely for reasons of political affront are entirely possible, though unpredictable.

In fact, leaving China has long been viewed as a privilege that the government can bestow, not a right of citizens, and many Chinese are barred from exiting. Exit bans and refusal of passports have been in place since 2012 for Tibetans and 2015 for Uyghurs. A passport application can put the applicant onto a watch list for security risks.

When the economy was humming and Chinese companies weighed heavily in portfolios, foreign nationals tended to ignore news about detentions, assuming that the detainee had broken a law. Now, with less economic growth to attract them, many investors are staying clear.

Appropriation of U.S. technology: National security motives often blur into commercial ones, making it difficult to find identify which people or companies may have been deputized to gather sensitive information. That information may include all varieties of U.S. technology.

The path by which international technology, brands, and business processes have entered China was explicitly designed by China's government from the start of the policy of "reform and opening." Market access and cheap labor were exchanged for foreign cash and technology. The formation of equity joint ventures, the original mechanism for this swap, was carefully regulated from start to finish, with a keen eye to assess the technology and intangible asset value and a policy of ensuring that Chinese parties to joint ventures were qualified to recognize, and often replicate, the skills and technologies being transferred. In some cases, the supervising government departments, technology valuation committees, and government research and design institutes have been directly involved in porting technology to competitors outside the joint venture. Through these channels, the shifting about of key technical employees, and other mechanisms, IP has poured onto astoundingly fertile land. The goal of China's joint venture policies was never a secret. But the efficiency and effectiveness of the transfer has been a startling revelation. Various bans on the sales of U.S. technology to China have gone a long way toward stemming the tide of reverse engineering and IP theft.

Economic distortion: Reporting on the macro economy remains driven by political target and thus is an unreliable indicator of growth or contraction. Misreporting of economic data has led U.S. companies to overinvest and to be goaded by their investors into ill-advised growth strategies. China's statistical system is one of goal seeking to reach a political target rather than deduction from data collected.

Macro-economic disruptions: China's principal strength is not technical prowess or political clout: it is scale. China's vast size presents a number of challenges for U.S. companies and consumers as they try to gain some distance:

- ***A big industrial supply chain***: China has long had the advantage of cheap capital, cheap energy and land, and cheap labor. Consequently, China hosts very large facilities that are costly to build: chemical plants, steel mills, aluminum smelters, electronics assemblers. These companies make essential components for all sorts of things – pharmaceuticals, consumer electronics, building materials. Other countries that welcome foreign capital – Vietnam, for example, or Mexico – cannot offer the same scale. International companies need to spread their bets by shifting a portion of production to other countries, but the U.S. is never going to end completely its trading and investment relationship with China. The good news is that China needs export sales and is exceedingly unlikely to close down exporting companies.
- ***Massive electronics base***: There is hardly a consumer electronic product that does not get components from and have assembly in China. U.S. companies that make power-control chips, printed circuit boards, optical assembly systems for DVD players, and other things deep in the interstices of industry are completely dependent on intermediaries based in China. Ending the operation of U.S. companies in China would lead to shortages of and price spikes for mobile phones, computers, automobiles, and all sorts of machinery. The U.S. market needs to remain open to China-assembled products.

- ***Size of financial products***: Alibaba is worth almost $250 billion, more than Toyota or Sony. Evergrande, just one Chinese developer, has filed for protection from over $27 billion in U.S. debt. Chinese companies listed on U.S. markets in total are valued at about $775 billion, and foreign holdings of Chinese bonds are over $500 billion. This scale suggests that a great number of Americans will be affected by a deflation in Chinese assets. Many of the bonds will default, and many of the listed companies will shrink to a fraction of their current size. Probably the best defense, perversely, will be to stagger the impact of falling Chinese asset values by raising audit and listing standards, such that some Chinese companies leave U.S. markets.
- ***Commodity demand***: China is the world's biggest consumer or biggest marginal consumer of almost all important commodities. As China's economy shrinks, so will global demand for iron ore, crude oil, copper, soy beans, potash, and other commodities. This will likely have a strong impact on the Australian economy and perhaps on Midwest U.S. states that export soybeans and corn to China, but globally and on the U.S. as a nation, the effect will be mild.
- ***Currency:*** China has long had a stated intention to supplant the U.S. dollar with some form of the Renminbi as the principal means of international payment. China has established Renminbi payment facilities with Russia, Saudi Arabia, Brazil, Iran, and a few other countries. This amounts to establishing a form of barter with countries excluded from the liberal international order, and the chance that the Renminbi will replace the U.S. dollar is zero. Americans do worry, however, that China will suddenly sell its cache of about $850 billion in U.S. Treasury bills and thereby drive down the price. Like the fear of dollar replacement, this fear is overblown. That is for two reasons: first, dollar assets must be sold for other dollar assets, and that would drive up the price of whatever asset was chosen. Other assets are less liquid than Treasuries and therefore more risky for the Chinese. Second, a rapid sale would push down the value of the bonds and therefore force the Chinese into a loss position. Finally, as long as China runs a trade surplus with the United States, it must buy Treasury bonds. China is unlikely to sacrifice its trade surplus.
- ***China-dominated industries:*** China is overwhelmingly dominant in the global supply of processed lithium for batteries, battery technology, certain rare earth minerals, such as Germanium, and electronics components, including diodes, transistors, LEDs, discrete semiconductors, and sensors. Many China-based companies design complex semiconductors, but they rely on high-end tools purchased from other countries and fabrication done in Taiwan. A sudden cutoff of electronics supply from China would be devastating to the Chinese economy but also disrupt U.S. supply, creating shortages and driving up prices.

Policy recommendations: Divestiture from companies that support the Uyghur oppression in Xinjiang, bans on investing in companies that build surveillance systems, bans on investing in Chinese military-associated companies are all necessary. It feels unsatisfactory to tell asset managers to limit the choices of their clients. But it is senseless to compile lists of Chinese companies that may not sell to the United States or buy high-end technology but then to allow U.S. money to flow freely into the same companies. Military technologies, the sale of opiates, private prisons, selling tobacco to minors, surveillance technologies, and instruments of torture, for example, may all provide superior returns. That does not mean we should support them.

To date, executive orders issued by the Biden Administration on the transfer of high-end technology to China and investment in certain technologies have been extremely effective and have greatly angered the Chinese. The 2022 CHIPS Act is also a step toward strengthening U.S. semiconductor manufacturing, design and research. More needs to be done.

In the end, value chains are extremely complex. Investor education may be the most effective tool for keeping U.S. money out of morally reprehensible areas. Just as the "Made in USA" label has been an effective strategy for getting buyers to pay a little more, we might consider other labeling strategies to make sure that the companies we buy from and invest in do not engage in practices we find horrifying.